No. 21104

In the United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA, APPELLANT

v.

HASKEL ENGINEERING & SUPPLY COMPANY, APPELLEE

On Appeal From the Judgment of the United States District Court for the Southern (Now Central) District of California

BRIEF FOR THE APPELLANT

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BRIEF FOR THE APPELLANT

OPINION BELOW

The memorandum opinion of the District Court (I-R. 196)[1] is not officially reported.

JURISDICTION

This appeal involves federal income taxes for the taxable years 1957, 1958, and 1959. The taxes in dispute were paid on August 1, 1963. A claim for refund was filed on August 5, 1963, and has not been rejected. Within the time provided in Section 6532

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[1] "I-R." and "II-R." references are to Volumes I and II of the record on appeal.

of the Internal Revenue Code of 1954, on March 10, 1964, the taxpayer commenced this action in the District Court to recover the taxes paid. (I-R. 117, 127-128.) Jurisdiction was conferred on the District Court by 28 U.S.C., Sections 1340 and 1346. The judgment of the District Court was entered on February 10, 1966. (I-R. 222-224.) Within 60 days thereafter, on April 8, 1966, a notice of appeal was filed by the United States. (I-R. 225-226.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the District Court erred in holding that taxpayer sustained its burden of showing an abuse of discretion in the Commissioner's determination of reasonable additions to taxpayer's bad debt reserve.

2. Whether the District Court erred in holding that taxpayer's "interest" payments to its stockholders with respect to certain "debentures" qualified for deductions.

3. Whether the District Court erred in holding that taxpayer's "redemption premium" payments to its stockholders with respect to the "debentures" qualified for deductions.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

Sec. 162. Trade or Business Expense.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expens-

es paid or incurred during the taxable year in carrying on any trade or business * * *

* * * *

(26 U.S.C. 1964 ed., Sec. 162.)

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * *

(26 U.S.C. 1964 ed., Sec. 163.)

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * *

(c) *Reserve for Bad Debts.*—In lieu of any any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * *

(26 U.S.C. 1964 ed., Sec. 166.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.166-4 *Reserve for bad debts.*

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve.*—(1) *Relevant factors.*—What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.*—In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

* * * *

(26 C.F.R., Sec. 1.166-4.)

STATEMENT

During the years 1946 through 1952 Richard L. Hayman and Don W. Driskel, who were mechanical engineers, operated the Haskel Engineering & Supply Company, a partnership whose business activities consisted of the design and development and the sale and service of various kinds of parts and equipment. Hayman had a 60 percent interest and Driskel a 40 percent interest in the partnership. During May and June, 1952, three new corporations and a new partnership were formed to carry on the various aspects of the old partnership. The taxpayer, Haskel Engineering & Supply Company, a California corporation, was organized in June, 1952, to take over the part of the business concerned with the wholesale distribution and retail sale of hydraulic parts and equipment. (I-R. 118-119, 121-122.)

In June, 1952, the old partnership transferred to taxpayer those of its assets that were needed in the operation of the hydraulic parts and equipment business. The following is a list of these assets and the values at which they were carried on the partnership books (I-R. 122):

	Value per Partnership Books
Inventories	$30,595.55
Account receivable	28,232.24
Furniture and fixtures	5,841.75
Leasehold improvements	3,377.38
Equipment	1,757.08
Automobiles	1,187.04
Prepaid rent	1,360.00
Prepaid insurance	195.47
Prepaid office expense	164.50
Deposits	27.75
TOTAL	$72,738.76

The form of the transfer of the partnership assets to taxpayer was an exchange of assets having a basis to the partnership of $8,738.76 and goodwill, which had not been shown on the partnership books but which was recorded on the corporation's books at $14,000, for 1,500 shares of taxpayer's no par value capital stock and, at the same time, an exchange of the inventories, accounts receivable and most of the furniture and fixtures, having a total basis to the partnership of $64,000, for taxpayer's "Series A Four Percent Registered Debenture Bonds" in the face amount of $64,000. (I-R. 121-123; II-R. 12-13.)

The "debentures"[2] that taxpayer issued to its stockholders had a stated term of 20 years. They were unsecured, did not provide for a retirement sinking fund and contained no provisions limiting the

[2] A copy of one of the "debentures" was received in evidence as plaintiff's Exhibit 13. (I-R. 130; II-R. 25.) A copy of one of the "debentures" is reproduced at page 23 of Volume I of the record.

payment of dividends, the incurring of additional liabilities, or the mortgaging of the corporation's assets. They provided for annual "interest" payments of 4 percent. They also provided for payment of a "redemption premium" of 2 percent of the amount of the "debentures" being redeemed times the number of years by which maturity was being accelerated, which, under their terms, could be as many as 18 years. (I-R. 23.)

Taxpayer never formally declared or paid any dividends with respect to its capital stock. (I-R. 126.) During the taxable years ended May 31, 1957, and May 31, 1958, taxpayer made "interest" payments of $2,599.92 and $2,053.26, respectively, on the "debentures." (I-R. 125.) In these years it also made the following "redemption premium" payments (I-R. 125):

Taxable Year Ending	Face Amount of "Debentures" Redeemed	"Redemption Premiums" Paid
May 31, 1957	$30,000	$ 9,600
May 31, 1958	32,000	10,500

On its tax returns for the years ended May 31, 1957, and May 31, 1958, taxpayer claimed deductions for these "interest" and "redemption premium" payments that it had made to its stockholders. (I-R. 125.)

Taxpayer employed the reserve method of accounting for bad debts. The average ratio of uncollectible accounts charged against the reserve to accounts receivable at the beginning of each year was 1.381 per-

cent for the taxable years 1954 through 1957, 1.2116 percent for the taxable years 1954 through 1958, and .93219 percent for the taxable years 1954 through 1959. As of May 31, 1958, and May 31, 1959, taxpayer's accounts receivable balances were $236,828.98 and $321,367.83, respectively. The balances in the reserve, before any additions for those years, were $3,426.51 and $2,078.54, respectively. On its returns for these years taxpayer claimed deductions of $3,313.80 and $1,800, respectively, for additions to the reserve. (I-R. 126-127.)

The Commissioner determined the reasonable additions to taxpayer's bad debt reserve for the taxable years 1958 and 1959 by applying to the accounts receivable balances at the end of each of these years taxpayer's average bad debt loss rate for the period 1954 through the year involved. Accordingly, the Commissioner determined that the additions to the reserve for the taxable years 1958 and 1959 were excessive by the amounts of $3,313.80 and $882.75, respectively, and to that extent disallowed the claimed deductions. The Commissioner also determined that taxpayer's "interest" and "redemption premium" payments with respect to its "debentures" did not qualify for deductions. The Commissioner determined tax deficiencies based on the disallowance of these deductions. (I-R. 127.)

Taxpayer paid the deficiencies determined by the Commissioner for its taxable years 1957, 1958 and 1959 and on March 10, 1964, no action having been taken on its claims for refund of the amount of the deficiencies commenced this suit in the District Court

to recover these taxes. (I-R. 127-128.) On January 14, 1966, the District Court filed a memorandum opinion (I-R. 196) holding that taxpayer was entitled to all of the deductions that it claimed. On February 10, 1966, the court accepted the findings of fact and conclusions of law submitted by counsel for the taxpayer (I-R. 212-220) and entered judgment in favor of taxpayer (I-R. 222-223). This appeal is taken by the Government from that judgment.

SPECIFICATION OF ERRORS RELIED UPON

1. The District Court applied an erroneous standard in deciding the amounts of the additions to taxpayer's bad debt reserve that qualified for deductions.

2. The District Court erred in holding that taxpayer had proven its entitlement to the bad debt deductions that it claimed.

3. The District Court applied an erroneous standard in deciding whether taxpayer's payments with respect to its "debentures" qualified for deductions.

4. The District Court erred in holding that the "debentures" that taxpayer issued to its stockholders constituted indebtedness within the meaning of Section 163(a) of the Internal Revenue Code of 1954.

5. The District Court erred in holding that taxpayer was entitled to deductions for its "interest" payments to its stockholders with respect to the "debentures".

6. The District Court erred in holding that taxpayer was entitled to deductions for its "redemption premium" payments to its stockholders with respect to the "debentures."

SUMMARY OF ARGUMENT

The questions presented on this appeal concern the correctness of the District Court's determinations with respect to certain deductions claimed by taxpayer in the computation of its taxable income for the years 1957, 1958 and 1959. We submit that the District Court applied incorrect standards in its consideration of these questions and erred in holding that taxpayer was entitled to the deductions that it sought.

1. Under the statutory provision permitting a deduction for a reasonable addition to a reserve for bad debts the Commissioner is vested with the discretion to determine what is a reasonable addition. A taxpayer seeking to controvert the Commissioner's determination of the amount of the addition that is required to bring the reserve to an adequate level must therefore show that it constitutes an abuse of his discretion. The ratio of accounts charged against taxpayer's reserve to its accounts receivable at the beginning of each year was a constantly improving one. Accordingly, the Commissioner's determinations of the proper additions to taxpayer's reserve, which were based on taxpayer's average bad debt loss rate for the period 1954 through the year in question, were not only reasonable, but favorable to taxpayer. The only evidence offered by taxpayer in support of its attempt to controvert the Commissioner's determinations was the testimony of two of its officers wherein they stated that they had analyzed taxpayer's accounts receivable and had decided that the amounts of the claimed deductions were proper additions to

the reserve. Since this unsupported, self-serving decision by taxpayer's officers as to what, in their opinion, constituted proper additions to the reserve did not show any error in the Commissioner's determinations, the court's holding that taxpayer was entitled to the claimed bad debt deductions was erroneous; for it improperly shifted to the taxpayer's officers the discretion to determine reasonable additions to the reserve and required the Commissioner to show an abuse of discretion on their part.

2. The District Court also applied an erroneous standard in determining that taxpayer's "interest" and "redemption premium" payments to its stockholders with respect to its "debentures" were deductible. In order to qualify for a deduction the taxpayer must show that what was done is in reality that which is contemplated by the statutory provision authorizing the deduction. The District Court, however, did not consider the true nature of the payments but, the Government not having shown any fraud in the issuance of the "debentures", held that the payments with respect to them were deductible. An examination of the substance of what was done, rather than merely of the forms used, compels the conclusion that these payments did not qualify for deductions as "interest * * * on indebtedness" or "ordinary and necessary expenses" of taxpayer's business.

Taxpayer's issuance of the "debentures" to its stockholders did not, in substance, create a true debtor creditor relationship between them. Almost all of the tangible assets that taxpayer required in its busi-

ness were transferred to it, in exchange for the "debentures", by its stockholders, who also personally guaranteed a line of bank credit in its behalf. The 20-year "debentures" that taxpayer issued to its stockholders were unsecured and contained none of the protective provisions that an arm's-length creditor making a long-term loan demands; no one but a stockholder would have advanced funds to the corporation on the basis of such an instrument. Moreover, the return that the stockholders were to receive with respect to the "debentures" was not the fixed compensation for the risks incurred that is normally received by a creditor, but a sharing in taxpayer's profits, which is the normal return of one making a capital investment. While the 4 percent "interest" rate provided for in the "debentures" was much less than the return that an outsider would have demanded for such an advance, the "debentures" also provided for "redemption premium" payments of as much as 36 percent of their face amount, which was many times greater than a normal redemption premium; so that the return to taxpayer's stockholders with respect to the "debentures" would bear no relation to the risks incurred in making the investment that they evidenced. Since the "debentures" in reality represented part of the capital investment in taxpayer's business, rather than true indebtedness within the meaning of the Internal Revenue Code, the payments constituted distributions of earnings with respect to equity interests, which are not deductible.

In any event, regardless of the true nature of the "debentures", the "redemption premium" payments that were made to taxpayer's stockholders were not deductible. These payments (at the rate of 32 percent) were not reasonable in amount, but were many times greater than normal redemption premiums. Since taxpayer's net cost of retaining the funds used to redeem the "debentures" would have been less than the yield on United States Government bonds, the early redemption was not to taxpayer's corporate advantage, but benefited only its stockholders. The payment of the "redemption premiums" was extraordinary and unnecessary and would not even qualify as a business expense under Section 162(a) of the 1954 Code, let alone as interest.

ARGUMENT

I

The District Court Erred in Holding That Taxpayer Had Proven Its Entitlement to the Bad Debt Deductions That It Sought

Taxpayer seeks deductions for additions to its bad debt reserve for the years 1958 and 1959 in the amounts of $3,313.80 and $1,800, respectively. The Commissioner determined that taxpayer was not entitled to an addition in 1958 and that a proper addition for 1959 was limited to $917.25. The District Court erroneously, we submit, sustained taxpayer's position.

In determining the income on which the federal income tax is levied, the statute provides a deduction from gross income for bad debts. Internal Revenue

Code of 1954, Section 166, *supra*. This provision allows a deduction as of right for any debt which becomes worthless within the taxable year (Section 166(a)), or, alternatively, it provides that there is "allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts" (Section 166(c)).

In any action for the refund of federal income taxes, the determination of the Commissioner is presumptively correct, and the taxpayer has the burden of disproving that determination by showing that he clearly comes within a statutory provision allowing the claimed deduction and by proving the amount of the deduction to which he is entitled. *Reinecke* v. *Spalding*, 280 U.S. 227, 232-233. In dealing with a deduction for a reasonable addition to a reserve for bad debts the Commissioner's determination is entitled to even greater weight, since he is vested by Section 166 (c) with the discretion to determine what is a reasonable addition. Accordingly, where, as in the instant case, taxpayer seeks to controvert the Commissioner's determination disallowing a claimed deduction for such an addition, the issue is whether the Commissioner has abused his discretion, and taxpayer has the burden of showing such an abuse of discretion. *Calavo, Inc.* v. *Commissioner*, 304 F. 2d 650, 653-654 (C.A. 9th); *Patterson* v. *Pizitz, Inc.*, 353 F. 2d 267 (C.A. 5th), certiorari denied, 383 U.S. 910; *Foster Frosty Foods, Inc.* v. *Commissioner*, 332 F. 2d 230, 232 (C.A. 10th); *Paramount Finance Co.* v. *United States*, 304 F. 2d 460 (Ct. Cl.); *S. W. Coe &*

Co. v. *Dallman*, 216 F. 2d 566 (C.A. 7th); *Maverick-Clarke Litho Co.* v. *Commissioner*, 180 F. 2d 587, 592 (C.A. 5th); *Morris Plan Ind. Bank* v. *Commissioner*, 151 F. 2d 976, 983 (C.A. 2d). This burden of proving an abuse of discretion has been described by this Court as a burden that "falls heavily on the taxpayer." *Calavo, Inc.* v. *Commissioner*, *supra*, 304 F. 2d, p. 654. See also *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner*, 317 F. 2d 829, 834 (C.A. 7th); *Patterson* v. *Pizitz, Inc.*, *supra*, 353 F. 2d p. 270; *Paramount Liquor Co.* v. *Commissioner*, 242 F. 2d 249, 259 (C.A. 8th).

The Court of Claims summed up the applicable principles as follows (*Art Metal Const. Co.* v. *United States*, 17 F. Supp. 854, 862-863):

> The use of the reserve system in connection with deductions for worthless debts was first permitted in the Revenue Act of 1921 (section 234(a)(5), 42 Stat. 254) and has been continued in substantially the same form. Prior to 1921 deductions for worthless debts could only be allowed when they were ascertained to be worthless and charged off. The new provision for the use of reserves constituted an important departure from the former revenue acts as far as worthless debts were concerned, and also a departure from the method employed with respect to other deductions, in that, by the use of the reserve method, deductions were thereafter allowable without regard to whether evidenced by closed and completed transactions. It is not without significance, therefore, that under the quoted provisions the additions to the reserve must be

> reasonable and allowable only in the discretion of the Commissioner. While the Commissioner's exercise of his discretion in this respect is subject to review (cf. *Blair* v. *Oesterlein Machine Co.*, 275 U.S. 220, 48 S. Ct. 87, 72 L. Ed. 249), his determination of a reasonable addition to a reserve is not to be lightly set aside. The burden is on plaintiff to show that the additions which the Commissioner has allowed to the reserve as deductions from income for the years involved are not reasonable. In this there is more than a mere presumption of the correctness of the Commission's determination. In addition, we are reviewing exercised discretion which has been confided in the Commissioner.

The Regulations promulgated by the Commissioner (Treasury Regulations on Income Tax (1954 Code), Section 1.166-4(b)(1), *supra*) provide that the reasonableness of an addition to the reserve for bad debts "will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of existing reserve." It follows that "In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year." Treasury Regulations on Income Taxes (1954 Code), Section 1.166-4(b)(2), *supra.* Thus, the crux of the matter is not whether the addition to the re-

serve for a particular year bears a reasonable relation to the sales for that year but whether the balance in the reserve is sufficient.[3] In order to prevail taxpayer was obliged to show that the Commissioner's determination that its claimed additions to its bad debt reserve were in excess of the additions that were required to bring the reserve to an adequate level was an abuse of his discretion. *Patterson* v. *Pizitz, Inc.*, *supra*, 353 F. 2d, pp. 268-269.

During the period from 1954 through 1959, taxpayer's bad debt loss rate (the ratio of the uncollectible accounts charged against its bad debt reserve during the year to its accounts receivable at the beginning of the year) was constantly decreasing. (I-R. 126.) It is apparent, therefore, that the Commissioner's determination as to what were reasonable additions to taxpayer's bad debt reserve for 1958 and 1959,[4] which was based on taxpayer's average bad debt loss rate going back to 1954 (I-R. 126-127), was, in the absence of a showing of special circumstances with regard to the collectibility of the accounts receivable that arose in 1958 and 1959, not only reasonable, but favorable to taxpayer.

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[3] It is clear that the reserve allowed by Section 166(c) is not a contingency reserve for possible future losses. *American State Bank* v. *United States*, 279 F. 2d 589-590 (C.A. 7th).

[4] The record shows (I-R. 126-127) that the Commissioner's determination of a reasonable reserve balance ($2,869.42) as of May 31, 1958, was, in fact, greatly in excess of the amount ($1,347.97) that was actually charged against the reserve during the following year.

Taxpayer offered no evidence of the existence of any special circumstances with regard to the 1958 and 1959 receivables. The only evidence offered by it in support of its attempt to controvert the Commissioner's determination was the testimony (II-R. 37-39, 93-96) of William Hannam, its accountant and attorney and one of its directors and officers (II-R. 5-6, 43-44), and of Richard Hayman, one of its two stockholders (I-R. 124), that at the end of each year the accounts receivable were analyzed according to their age and a decision was then reached as to the amount that taxpayer's officers felt was a proper addition to the reserve for bad debt.[5] Certainly, taxpayer did not meet its burden of proving that the Commissioner's determination was arbitrary by showing this unsupported, self-serving decision by taxpayer's officers as to what, in their opinion, constituted proper additions to its bad debt reserve.

The District Court's finding (I-R. 218) that the determination by the Commissioner of the reasonable addition to taxpayer's reserve was erroneous because it was without regard to anticipated future events is wholly without support; for there was no evidence whatsoever of anticipated future events that would affect the collectibility of the 1958 and 1959 accounts. In view of this lack of evidence, the court's findings

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[5] Hannam stated (II-R. 39-42), on cross-examination, that in the early 1950's, after the cessation of the Korean hostilities, the size of taxpayer's sales decreased, and the number of its customers increased. He was unable, however, to state what effect, if any, this had on taxpayer's bad debt loss experience. (II-R. 40-42.)

(I-R. 218) and its comments during the trial (II-R. 117) with respect to this issue[6] indicate that it applied an erroneous standard, placing the burden of proof on the Government to negate the existence of any facts that would make the additions to the reserve that were decided on by taxpayer's officers reasonable ones. Instead of requiring taxpayer to prove an abuse by the Commissioner of his discretion to determine the amount of the bad debt deduction to which taxpayer was entitled, the District Court improperly regarded that discretion as vested in taxpayer's officers and required the Commissioner to show that they had abused it. Since taxpayer failed to prove that the Commissioner had abused his discretion, or even that the additions to the reserve decided on by its officers were reasonable, the District Court erred in not entering judgment in favor of the Government on this issue.

II

The District Court Erred in Holding That Taxpayer Was Entitled to Deductions for the Payments to Its Stockholders With Respect to the "Debentures"

A. *The District Court applied an erroneous standard*

The District Court also applied an erroneous standard in deciding the questions of the deductibility of taxpayer's payments to its stockholders with respect to the "debentures". The principle that tax consequences depend on the economic substance of what

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[6] The District Court's memorandum opinion (I-R. 196) ignored this issue.

was done, and not on the forms used, is elementary in the law of taxation. See, e.g., *Gregory* v. *Helvering*, 293 U.S. 465; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 266-267; *Trousdale* v. *Commissioner*, 219 F. 2d 563, 568 (C.A. 9th); *Schulz* v. *Commissioner*, 294 F. 2d 52, 56 (C.A. 9th). In order to qualify for a deduction, therefore, a taxpayer must show that what was done, as a matter of economic reality, lies within the intent of the statutory provision authorizing the deduction. An examination of the forms and labels employed by the parties and of the effect given to the transaction under state law represents only the beginning, and not the end, of the inquiry.

The Internal Revenue Code does not permit a deduction for a corporation's distributions of earnings and profits to its stockholders. Accordingly, taxpayer's "interest" and "redemption premium" payments with respect to its "debentures" are deductible only if, looking beyond the formal arrangements to the underlying economic realities, they constituted "interest * * * on indebtedness" [7] or "ordinary and necessary" business expenses [8] and not merely distributions to stockholders. The District Court's holdings that the "interest" and "redemption premium" payments were deductible were not, however, based on a determination that these payments in reality constituted "interest * * * on indebtedness" or "ordi-

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[7] Internal Revenue Code of 1954, Section 163(a), *supra*.

[8] Internal Revenue Code of 1954, Section 162(a), *supra*.

nary and necessary" business expenses within the meaning of the respective statutory provisions. The District Court believed that the issue presented here was simply whether the issuance of the "debentures" (II-R. 46) "is a legitimate tax plan or whether it is a subterfuge, has some fraudulent aspects." See also, to the same effect, I-R. 196; II-R. 47, 99, 115-116, 138, 140, 185-186, 194-195. Under the District Court's approach the inquiry was erroneously limited to ascertaining whether the "debentures" were enforcible as debt under state law and whether their issuance constituted a fraud against the United States.[9] Determining that the "debentures" were enforcible under state law, and the Government not having shown the presence of fraud, the court held that taxpayer was entitled to the deductions that it sought with respect to the "debenture" payments (I-R. 196), without regard to the true nature of the payments.

But the question here was not whether fraud had been committed; the Government made no allegations of fraud. Rather, the question was: What was the essential nature of the payments to taxpayer's stockholders? Taxpayer had the burden of demonstrating that the payments came within the purview of Sections 162(a) or 163(a). See, e.g., *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593; *Tressler* v. *Commissioner*, 228 F. 2d 356, 362 (C.A. 9th);

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[9] Accordingly, the District Court sustained taxpayer's objections to the Government's attempts to introduce evidence as to the true nature of the transaction. (II-R. 99, 104, 177.)

O. H. Kruse Grain & Milling v. *Commissioner*, 279 F. 2d 123, 125 (C.A. 9th); *Wilbur Security Co.* v. *Commissioner*, 279 F. 2d 657, 661 (C.A. 9th). Since the District Court misunderstood the nature of the inquiry and applied a wholly incorrect standard its decision cannot stand. Cf. *United States* v. *Intermountain Furniture Mfg. Co.*, 363 F. 2d 554 (C.A. 10th); *Municipal Bond Corp.* v. *Commissioner*, 341 F. 2d 683, 690-691 (C.A. 8th).

B. *The "debentures" in reality constituted part of the capital investment in taxpayer*

There is no doubt that an investor may simultaneously occupy the dual status of stockholder and creditor in relation to a corporation. One who, as a stockholder, has made a capital investment in the corporation in order to obtain a share of its profits may also make an advance of additional funds to it that constitutes "indebtedness" for tax purposes. In order for the stockholder's advance to constitute such indebtedness, however, it must create a true debtor-creditor relationship between the corporation and the stockholder. Where, as in the instant case, the stockholders' advances are in proportion to their stockholdings the use of a conventional debt-type instrument is not indicative of the true nature of the advances; since the stockholders are already in full control of the corporation there is no reason to include in the instrument (even if it in reality represents a capital investment rather than indebtedness) the control provision ordinarily found in an equity instrument.

Looking to the substance of the transaction wherein the partnership assets were transferred to taxpayer it is apparent that taxpayer's issuance of the "debentures" to its stockholders did not create a true debtor-creditor relationship between them, but only evidenced an additional part of the stockholders' capital investment in the corporation. Upon taxpayer's organization it received from Hayman and Driskel in the form of a capital investment $9,000 of the partnership assets that it required in its business.[10] (I-R. 122.) The other $64,000 of essential assets were transferred to taxpayer by Hayman and Driskel in exchange for the "debentures". (I-R. 122-123.) In addition, Hayman and Driskel obtained $40,000 of bank credit for taxpayer by personally executing a continuing guarantee on its behalf.[11] (II-R. 108-109.) The "debentures" that Hayman and Driskel received from taxpayer, which were payable in 20 years, did not provide for any of the protective pro-

[10] The remainder of their formal capital investment in taxpayer consisted of goodwill which they valued at $14,000.

[11] Since the bank also required Mrs. Hayman to execute the guarantee (II-R. 109) the bank apparently was not employing the guarantee merely as a means of preventing Hayman and Driskel from disposing of their interests in the corporation but was also looking to these individuals' personal credit to support its loans to taxpayer.

The effect of this guarantee was the same as if Hayman and Driskey had subordinated their claims with respect to the "debentures" to taxpayer's obligations to the bank. In the event taxpayer failed, Hayman and Driskey would have had to use funds that they received with respect to the "debentures" to satisfy taxpayer's obligations to the bank.

visions that an arms-length creditor making a long-term loan will demand.

The essential difference between a creditor and a stockholder is that the latter intends to embark upon the corporate adventure, taking the risks of loss contingent upon it so that he may enjoy the chances of profit. The creditor on the other hand, does not intend to take such risks so far as they may be avoided. *Helvering* v. *Richmond, F. & P. R. Co.*, 90 F. 2d 971, 974 (C.A. 4th); *Commissioner* v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182, 186 (C.A. 3d). This willingness to subject his investment to the risks of the enterprise in return for a part of its profits is the hallmark of the stockholder and is what distinguishes him from the creditor. Since the creditor seeks to avoid subjecting his funds to the risks of the business, before he will make a loan he requires some security for its repayment. If the loan is a short-term one, he may be content to rely on his right to share with the other creditors in the assets of the corporation in the event the business fails. Where a long-term loan is involved the creditor will not be satisfied to have to depend on this right alone, for he realizes that large portions of the corporation's assets may be dissipated by the payment of dividends and that his security in its assets may be diluted by its incurring large amounts of additional indebtedness, especially if that indebtedness is secured by liens on its assets. In order to minimize his risks the long-term creditor will demand that the instrument evidencing his loan contain at least some protective

provisions, e.g., liens on assets, restrictions on dividends, restrictions on the incurring of additional liabilities and on the mortgaging of assets, and provisions for a retirement sinking fund.[12]

The 20-year "debentures", containing no such provisions clearly failed (II-R. 176-177, 179-180), as the District Court recognized (II-R. 186), to comply with the arm's-length standards that would be demanded by anyone other than a person who, like Hayman and Driskel, held stock in proportion to the "debentures". No one but a stockholder would advance funds to the corporation on the basis of such an instrument.

Moreover, the return that the stockholders were to receive through the "debentures" for the long-term commitment of their assets to the risks of the business was not the return of a creditor, i.e., a fixed amount that compensates for the risks incurred in making the advance, but rather, the return of one making a capital investment, i.e., a sharing in taxpayer's future profits. It is apparent, as Bruce Ricks, the Government's expert witness testified (II-R. 181, 182), that the 4 percent "interest" rate stated in the "debentures"[13] was not an adequate rate of re-

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[12] See 1 Dewing, Financial Policy of Corporations (5th ed.), pp. 228-230. An example of such protective provisions may be found in *Kelly* v. *Central Hanover Bank & Trust Co.*, 11 F. Supp. 497, 502, fns. 2 and 3 (S.D. N.Y.), reversed and remanded on procedural grounds, 85 F. 2d 61 (C.A. 2d).

[13] William Hannam, one of taxpayer's directors and officers, testified (II-R. 34-35) that this rate "was slightly in excess of what savings and loans were paying at that time on deposits."

turn for an unsecured 20-year obligation, not covered by any protective provisions, of a relatively new business whose invested capital, which included $14,000 assigned to goodwill, was only $22,739. Certainly, the rate of return that would be demanded by an outsider would be substantially in excess of the rate that savings and loan associations were then paying on their deposits, which are normally insured by an instrumentality of the Federal Government.[14] The "debentures" also provided for payment of a "redemption premium" of 2 percent of the face amount of the "debentures" that would be redeemed prior to the expiration of 20 years, times the number of years by which redemption would be accelerated—which could be as many as 18 years. The amount of the "redemption premium", which could have been as high as 36 percent (the "premium" actually paid was 32 percent (I-R. 217)), was greatly in excess of the 3 to 5 percent or one year's interest on the principal amount being repaid that is normally provided for a redemption premium (see Winn and Hess, The Value of the Call Privilege, 14 Journal of Finance, 182, 187 (1959); II-R. 178).[15] Thus, the payments that

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[14] National Housing Act, c. 847, 48 Stat. 1246, Sec. 403 (12 U.S.C. 1964 ed., Sec. 1726).

[15] Mr. Hayman, one of taxpayer's two stockholders, suggested in his testimony (II-R. 83-85) that this extraordinarily large "redemption premium" gave the "debentures" marketability. It is clear, however, that an acceleration provision with a high redemption premium does not increase marketability, especially where the basic rate of return provided for in the instrument is inadequate. The function of a true re-

taxpayer's stockholders would receive under these two non-standard provisions of the "debentures" would bear no relation to the risk incurred in making the investment evidenced by these instruments, but would depend on the amount of taxpayer's earnings and on how much of these earnings the stockholders desired to withdraw. The nature of the return that taxpayer's stockholders were to receive, and in fact did receive, with respect to the "debentures" further emphasizes that in reality these instruments represented part of the capital investment in taxpayer's business. The District Court's conclusion that the "debentures" constituted indebtedness within the meaning of Section 163(a) was clearly wrong. Since no one who was not a stockholder would have made the advances to the corporation that were evidenced by the "debentures" and since the "debentures" permitted the stockholders, to whom they were issued, to withdraw part of the corporation's accumulated earnings, to regard the "debentures" as creating indebtedness within the meaning of the statute was to subvert substance to mere form. See *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39, 46 (C.A. 2d); *Wilbur Security Co.* v. *Commissioner*, *supra*, 279 F.

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demption premium is to compensate the investor for the costs of reinvestment and the possible loss of income that would result if a lower level of interest rates prevailed at the time of reinvestment. (See Winn and Hess, *supra*, p. 187.) An investment premium does not in any way compensate for an inadequate basic rate of return, since it does not increase the investor's security position and since it is payable only if the corporation elects to accelerate the redemption.

2d, p. 662; *Affiliated Research, Inc.* v. *United States*, 351 F. 2d 646, 649-650 (Ct. Cl.); *O. H. Kruse Grain & Milling* v. *Commissioner*, *supra*, 279 F. 2d, p. 126; *Gilbert* v. *Commissioner*, 248 F. 2d 399, 407 (C.A. 2d), on appeal from remand, 262 F. 2d 512 (C.A. 2d), certiorari denied, 359 U.S. 1002.

C. *In any event, the "redemption premium" payments were not deductible*

Regardless of the nature of the "debentures", the "redemption premiums" paid with respect to them were not deductible.[16] Where, as in the instant case, the payments are made to controlling stockholders it is necessary to scrutinize the transaction to make certain that the payments are reasonable in amount, since the transaction is not at arm's-length. *Baltimore Steam Packet Co.* v. *United States*, 180 F. Supp. 347, 350 (Ct. Cl.). The District Court failed to do this.[17] Although taxpayer made no such showing the court allowed the deductions that it sought with respect to these payments. Scrutiny of the transaction

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[16] Under our contention that the "debentures" in reality represented a capital investment, the "redemption premium" payments constituted payments with respect to stock (1954 Code, Section 312(a)), which are not deductible. This portion of the argument, however, assumes, *arguendo*, that the "debentures" constituted indebtedness for tax purposes.

[17] The fact that the District Court, upon finding that the "debentures" constituted indebtedness within the meaning of Section 163(a), held (I-R. 196) that "JUDGMENT SHALL, THEREFORE, BE for the plaintiff [taxpayer], as prayed", shows that the court allowed the claimed deductions to taxpayer without considering the question of whether the "redemption premium" payments qualified for deductions.

would have shown clearly that the payments did not qualify for deductions.

The "redemption premium" payments that were made to taxpayer's stockholders were not reasonable in amount, but, as we have shown, were many times greater than what is normally paid as a redemption premium. That these payments were in reality distributions of earnings to taxpayer's stockholders is illustrated by a simple analysis of the cost incurred by the corporation on the early redemption of the "debentures" as compared to the cost of paying the annual "interest". The net cost to taxpayer of retaining the funds that it used to redeem the "debentures" would have been a mere 2 percent per annum. In 1957 and 1958, when the redemptions took place (I-R. 125), United States Government bonds (the safest possible investment) were yielding a return of at least 3 percent. See N. Y. Times, June 1, 1957, p. 24, cols. 7 and 8, April 17, 1958, p. 51, cols. 7 and 8. Obviously, it would have been to taxpayer's corporate advantage to have retained these funds for the possible future needs of its business and to receive income therefrom, rather than hastening to redeem the "debentures" merely because corporate earnings were high. (II-R. 36-37, 92-93.) Under the circumstances the payment of the "redemption premiums" was extraordinary and unnecessary and would not even qualify as a business expense under Section 162(a) of the 1954 Code, *supra*, let alone as interest.

CONCLUSION

The District Court's decision allowing taxpayer the deductions that it sought is based on incorrect standards and is clearly erroneous. The judgment below should be reversed and this case remanded to the District Court with instructions to enter judgment for the United States.

Respectfully submitted,

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January, 1967.

Certificate

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ________________ day of January, 1967.

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Attorney

APPENDIX

EXHIBITS

	Identified	Offered	Received
Plaintiff's Exhibits 1 through 28 (described at I-R. 129-131)	II-R. 23	II-R. 23	II-R. 25
Plaintiff's Exhibit 29	II-R. 88-89	II-R. 90	II-R. 90
Defendant's Exhibit A	II-R. 109	II-R. 128	II-R. 128

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